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# EQUITY-BASED CROWDFUNDING AS AN ALTERNATIVE FOR FUNDING OF STARTUPS: TRENDS IN BRANZILIAN CONTEXT

**LUCIA FERNANDA DE CARVALHO**
UNINOVE – Universidade Nove de Julho
prof.fernandacarvalho@gmail.com

**FABRÍCIO GARCIA IMBRIZI**
UNINOVE
fabricio.imbrizi@gmail.com

**SILVIA NOVAES ZILBER TURRI**
UNINOVE - Universidade Nove de Julho
silviazilber@gmail.com

**EMERSON ANTONIO MACCARI**
UNINOVE - Universidade Nove de Julho
emersonmaccari@gmail.com

# EQUITY-BASED CROWDFUNDING AS AN ALTERNATIVE FOR FUNDING OF STARTUPS: TRENDS IN BRANZILIAN CONTEXT

**Resumo**

Existem inúmeras maneiras de levantar capital para financiar uma empresa ou ideia, como empréstimo bancário, mercado de ações, private equity, venture capital e investidores anjo. Considerando o contexto de empresas sementes e startups, o leque de possibilidades é limitado para algumas opções. Como alternativa, nos últimos anos, crowdfunding, que derivou de crowdsourcing e financiamento de capital, aparece como uma opção relevante para levantar o dinheiro da multidão. Esta pesquisa exploratória foi realizada para investigar as principais características de crowdfunding baseada em ações e como ele pode contribuir para angariar fundos para startups no contexto brasileiro. Usamos revisão bibliográfica, investigação documental e análise de conteúdo para apoiar esta investigação. Encontramos uma possível tendência de difundir essa modalidade de captação de recursos em todo o mundo. No entanto, devido a entraves burocráticos, ainda está em um estágio embrionário no Brasil.

**Palavras-chave**: financiamento coletivo, equidade, startups.

**Abstract**

There are numerous ways to raise capital to finance a company or idea such as bank loan, stock market, private equity, venture capital, and angel investors. Considering the context of seed and startups companies, the range of possibilities is limited for few options. As an alternative, in the last years, crowdfunding, which derived from crowdsourcing and capital funding, appears as a relevant option to raise money from crowd. This exploratory research was undertaken to investigate the main characteristics of equity-based crowdfunding and how it can contributes to raise funds for startups in the Brazilian context. We used literature review, documentary investigation, and content analysis to support this investigation. We found a possible trend of spreading fundraising this modality throughout the world. However, due to bureaucratic hurdles, is still in an embryonic stage in Brazil.

**Keywords**: crowdfunding, equity, startups.

## 1 Introduction

There are several ways to raise funds in the market, such as bank loan, stock market, private equity, venture capital, and angel investors. The companies' size (micro, small, medium, large), the nature of the ownership (open or close), the maturity level (seed, startup, intermediate, mature), the type of market (e.g. high technology, agribusinesses, industry) and others factors influence the means to find credit to execute the companies' projects. Despite these available means, raising funds is especially challenging for seed and startup companies (Heminway, 2014; Manchanda & Muralidharan, 2014; Mashburn, 2013).

Ouimet & Zarutskie (2014) days that differential dynamics between young and old firms raise important questions. Young firms are often associated with an up or out dynamic. Young firms have high failure rates, but, conditional on surviving, young firms exhibit higher average growth rates as compared to older firms. They believes that young and small firms are startups.

Crowdfunding emerges as a good alternative for raising funds in certain contexts. Mollick (2014) defines it as the effort of individuals and business groups - cultural, social and nonprofit - to finance their ventures by relying on small contributions from a large number of people who use the internet without financial intermediaries. In 2012, worldwide crowdfunding platforms raised US$ 2.7 billion from over 1.1 million campaigns. Eight hundred and thirteen platforms are estimated worldwide. US$ 5.1 billion was expected to be raised in 2013. In the same period, crowdfunding platforms in the aggregate reportedly raised approximately US$ 2.8 billion worldwide. This huge amount of money explains the increased interest in this issue (Mashburn, 2013; Massolution, 2013).

This study was undertaken to investigate the main characteristics of equity-based crowdfunding – a type of crowdfunding related to private equity – and how it can contributes to raise funds for startups in the Brazilian context. We believe that this research can contribute to the better understanding of this new funding mechanism in developing countries considering the differences of economy, legislation, and market that exist in different countries in the world.

To sustain the results, the research follows with a review of literature that aimed understand the financing of startups, the crowdfunding environment.Will also be presented a literature review about some types of financing of startups. Then we present a current overview of the equity crowdfunding in Brazil. Finally, the last section presents the conclusion summarizing the findings of the research, the contributions for academia and practice, and suggestions for future works.

## 2 Possibilities Financing of Startups

Entrepreneurs from startups, in general, need external financial resource to develop their companies from an initial to a maturate stage (Zachary & Mishra, 2013). Despite their willingness to find some source of financing, the lack of credibility and the historical failures of startups play against them. Since over than 90% of startups fail, and five of seven years after their foundation, just 30% are well successful, it is difficult to raise funds (Cusumano, 2013).

The limited availability of capital is common for startups. These companies do not have significant cash flow that ability them to access banking financing (Heminway, 2014). Furthermore, it is more complex to make decisions about financing for startups since there are little reliable data and a high risk related to the finances of the owners and the company (Gartner, Frid, & Alexander, 2012). Although they have high potential of return on investment, almost time they do not have financial and managerial resources to do it (Ramalho, Furtado, & Lara, 2011).The most traditional and known source of financing available for startups are: the owner's capital; the family and friends' capital, venture capital, angel investors, and the government (Gartner et al., 2012). Now, we will briefly describe the concepts behind venture capital and angel investors.

Venture capital firms are important intermediates in financial market who provide capital for new businesses that have difficult to raise funds (Dos Santos, Patel, & D'Souza, 2011). There is no strict regulatory definition of the venture capital industry but, Amit, Brander, & Zott (1998) speaking that, venture capital firms provide privately held "entrepreneurial" firms with equity, debt, or hybrid forms of financing, often in conjunction with managerial expertise. They have rigorous selection criteria according to their models of investment to make decisions about financing for startups (Mashburn, 2013). These firms have made few investments in startups in early-stage (Ramalho et al., 2011) since it is depends on the perspectives of profits (Gompers & Lerner, 2004). Some of these investments are made in startups that have better chances to be quickly a big company (Cusumano, 2013).

These firms have funds of investments classified as high risk and, consequently, with a potential of high return on investment. They buy stocks and/or shares with subscription rights of private companies. They also develop mechanisms to reduce the risk of failure such as hiring professionals with high technical or managerial skills to work in the startups. It contributes with the management and governance to protect the interests of shareholders that includes value generation and making profits (Dos Santos et al., 2011; Ramalho et al., 2011).

The venture capital funds represent 50% and 60% of the British and American market of private equity, respectively. In Brazil, the scenario is quite different because the Brazilian tax system does not incentive the investment via venture capital in startups (Ramalho et al., 2011). Some of these funds have been pointed to conduct prematurely some startups to Initial Public Offers (IPOs) which affect negatively these companies and, consequently, the venture capital market (Manchanda & Muralidharan, 2014). According to the Brazilian Association of Venture Capital (ABVCap), angel investors have shares in private companies varying from 15% to 30% (Ramalho et al., 2011). Despite this opportunity for both – funders and owners, recent data demonstrate that angels are changing their investments for more maturate companies, avoiding seed companies (Mashburn, 2013).

Angel investors are individuals or groups of individuals with previous background as executives and generally with large experience in (dis)investments in private equity and venture capital which who traditionally fund seed and startups business with little amounts. They are also a rich source of knowledge for management, couching, networking and raising funds. Angel investors are a relevant link between startups and venture capital funds since the companies evolve for a mature stage (Mashburn, 2013; Ramalho et al., 2011).

Angel investors act in different and structured markets (Zachary & Mishra, 2013). The participation of them in the business must be the sufficient to avoid any further problem with the entrepreneurs. It is important to keep the owners motivated, engaged to implement their idea, and with sufficient power to raise funds from others means (Gompers & Lerner, 2004). Similary with venture capitalists, angels investors monitor the progress of their portfolio firms and contribute value-adding services in addition to merely providing financial resources (Vanacker, Collewaert, & Paeleman, 2013).

So far, despite the similarities between venture capitalists and angel investors, there are differences in operation modes. Vanacker, Collewaert, & Paeleman (2013) exemplify that within a venture capitalist firm one can draw on the expertise and experience of multiple investment managers. In other side, angels mainly have to rely on themselves to provide valuable advice and information. Taken together, this suggests that VC investors may have a broader knowledge base than angels to draw from, enabling them to bring more opportunities to the entrepreneur's attention and to offer them a broader perspective.

A new opportunity to raise funds for new businesses is emerging with a form of collective financing. Crowdfunding emerged as a new source of financing to fill some financing gaps for startups (Mashburn, 2013). The next section will described in detail on crowdfunding, especially about equity-based type.

## 3 Crowdfunding

The practice of raise money from a crowd for the benefit of a particular member dates around the middle of 19th century. It was observed in rotating savings and credit associations, and credit cooperatives. The crowd was composed main of people who know each other, such as families, friends, and neighbors (Attuel-Mendes, 2014). This section will discuss the concept of crowdfunding and the four types of return currently offered. Moreover, we will see some of the reasons to avoid and / or join the crowdfunding appointed by some authors.

### 3.1 Concept and Typology

Recently, companies use the internet openly to address several problems still unanswered for those interested in solving them, been them experts, scientists, or curious, independent of their cultural or educational level. Monetary amounts usually are paid as a reward for those who reach the expected results by firms. To the open outsourcing of a task commonly performed by an employee to a large group of unknown people it calls crowdsourcing (Howe, 2006, 2009).

In the wake to find solutions with a large mass of people, rises the concept of crowdfunding, which goal is to collect money to invest in a new idea, using mainly social media and social networks on internet. It means looking for different sources of funding for traditional bank loans, investment funds, private equity, venture capital, and sophisticated investors. The focus is rise money openly from a large public, in which each individual contributes a small portion in the form of loan, profit sharing, share of capital, donation, or advance purchase of the product to be developed. According to this definition, it is possible to identify three actors: the funders who provide money, the creator who receive money and the on-line platform who intermediate this transaction (Agrawal, Catalini, & Goldfarb, 2011; Belleflamme, Lambert, & Schwienbacher, 2012; Blanck & Janissek-Muniz, 2014; Janissek-Muniz, 2014; Manchanda & Muralidharan, 2014).

There are four types of crowdfunding according to the return offered to the funder: donation, reward/pre-ordering, lending, and equity. Some crowdfunding platforms may work with more than one type simultaneously (Attuel-Mendes, 2014; Bradford, 2012; Massolution, 2013; Mollick, 2014). Table 1 illustrates each one and their main definition.

Table 1: Types of crowdfunding

| Type | Definition |
|---|---|
| **Donation** | Funders give money for a charitable cause. They also can finance non-profit organizations. This is not related to microfinance since it not relies on credit. |
| **Reward/Pre-ordering** | Funders receive something for their funds such as a gift, a free sample of the product, their names added to credits of a movie, the opportunity to meet the creators, etc. It does not include any kind of financial return such as interest or profit sharing. |
| **Lending** | Funders lend money waiting receive it back plus interest or fee. In the case of micro-loan, they may be more interested in social well promoted by the company than returns. |
| **Equity** | Funders give money waiting profit sharing and/or share of capital. In this case it is essential to have a regulatory legislation. |

Source: adapted from Bradford (2012), Massolution (2013), Mollick (2014) and Attuel-Mendes (2014)

In regard to these types, the right of property and financial legislation are important to be evaluated. In general, the right of property is assigned to the creator instead of the funders. Each country has its own legislation about lending money and acquiring securities, but almost all don't cover crowdfunding (Attuel-Mendes, 2014; Bradford, 2012).

Donation-based crowdfunding is the main model used for funding art and humanitarian sciences, putting funders as philanthropists (Bradford, 2012; Mollick, 2014). Reward-based is the most used nowadays (Mollick, 2014). Equity-based is a recent form of crowdfunding and is considered illegal in countries that do not have regulation yet (Manchanda & Muralidharan, 2014). Najjarian (2013) criticized equity-based since he believes that it is easier to capture savings on internet without any cost to register or supervision to capture, compared to capital market, and stock market. This subject will be discussed in more detail in a specific section.

Belleflamme, Lambert, & Schwienbacher (2012) suggested that crowdfunding allows for price discrimination with pre-ordering as an instrument. To implement it, it is necessary to consider the amount of capital to be raised to cover the initial costs to produce the new product, in relation to the numbers of pre-ordering consumers and others consumers. There is a boundary among raising money between traditional funding and crowdfunding. Creators prefer pre-ordering if the initial capital required is relatively small if compared with the market size. Otherwise, they prefer profit sharing when the principal amount is large. Funders expect to be consumers of the product in the future or in some way benefit, the community created around the product.

The increases of platforms that emerge each year enforce creators and funders to take more time searching them. They are willing to find a trustful platform that provide the tools, resources and projects that best meet their needs and expectations. To deal with this challenge, (Attuel-Mendes, 2014) suggest the creation of a brokerage platform that centralizes information of many crowdfunding platforms. He believes that it will help creators and funders make better decisions.

## 3.2 Reasons to Avoid or to Adhere Crowdfunding

Funders and creators have different motivations to engage in crowdfunding. Creators participate to following: i) Raise funds, almost time quickly. ii) Establish online and sometimes off-line connections with funders and other creators for long-term. iii) Gain approval for themselves and their work. iv) Learn new fundraising skills gaining experience in other areas, such as marketing, communication, management, risk taking, and financial planning. v) Expand awareness of work through social media, just not to publish but to dialog to general public too. vi) Maintain control over their work instead of losing control to the investor (Gerber, Hui, & Kuo, 2012; Gerber & Hui, 2013; Manchanda & Muralidharan, 2014; Mashburn, 2013).

Funders participate in crowdfunding to the following: i) Seek rewards, such as an acknowledgement (e.g. movie credits), a tangible artifact (e.g. a CD) or an experience (e.g. a dinner with the creator). ii) Support creators with whom they are connected by friendship, kinship or common interest. iii) Engage and contribute to a trusting and creative community being part of it. iv) Support causes that are consistent and compatible with their beliefs (Gerber et al., 2012; Gerber & Hui, 2013).

On the other hand, funders and creators have different reasons to avoid crowdfunding. Creators avoid because: i) they believe that they cannot achieve the target audience or offer any adequate reward to funders. ii) They want to avoid a public failure that could threat the chance to raise future investments and harm their reputation, and having the idea stolen. iii)

They do not have the time and resource to deal with a large audience. Founders avoid because they don't trust creators regarding the effective use of funds (Gerber & Hui, 2013; Manchanda & Muralidharan, 2014).

Online platforms of crowdfunding can support early stage entrepreneurs regardless the distance between them and investors that is a common concern when providing funding in traditional market. The early support of friends and family plays an important role to boost the investment of others investors distributed geographically (Agrawal, Catalini, & Goldfarb, 2011). Friends, family, and social network followers are the main funders and are doing it for the first time. They are more likely to fund in the first and last week of the project's funding cycle compared to the middle period. This is even more important in reward-based crowdfunding compared to the others types (Kuppuswamy & Bayus, 2014). Individual social capital has a significant positive impact on the probability to reach the target funding, while territorial social capital has no significant effect (Giudici, Guerini, & Rossi Lamastra, 2013).

Kuppuswamy & Bayus (2014) also found that the potential funders are influenced by how much of the goal has already been achieved; the creators tend to increase the posting updates to draw attention to their projects, as the deadline is approaching; for reward-based crowdfunding, there is no evidence that funders use other's supporter decisions to infer project quality; and the contribution fall drastically when the creators reach their goals. Wash (2013) found that people tend to donate more to complete a project goal in a donation crowdfunding context. Funders are also more likely to return and donate large amount of money in the next donation.

## 4 Equity-based crowdfunding

As described in Table 1, equity-based crowdfunding is a type where funders give money waiting profit sharing and/or share of capital (Bradford, 2012; Massolution, 2013; Mollick, 2014; Attuel-Mendes, 2014). Offering securities to the crowd is a recent phenomenon with great potential of growth as a response to traditional capital funding for startups (Heminway, 2014).

To boost the equity-based crowdfunding, on April 5, 2012, the Jumpstart Our Business Startups (JOBS) Act was signed into law by United States that covers crowdfunding (Bardford, 2012; Attuel-Mendes, 2014). This Act is stimulating some initiatives such as the application of rules about obligate disclosure, question about who is attending crowdfunding, and issues on shareholders' rights and maintenance of the market integrity (Heminway, 2014).

Ley and Weaven (2011) suggested ten factors that influence the adoption of crowdfunding in start-up financing. These factors were divided into three groups: investor specific factors, ex-ante investment factors, and ex-post investment factors. Table 2 illustrates the ten factors and their definition.

Table 2: Factors that influence the adoption of crowdfunding in start-up financing

| Factors | Definition |
|---|---|
| **Investor specific factors** | |
| **Crowd composition** | The crowd is composed of suitably informed and experienced investors. |
| **Ex-ante investment factors** | |
| **Deal screening** | Deal screening specific to the composition of the crowd. |
| **Deal referrals** | To engage external deal referrals from a trusted network. |
| **Information sensitivity** | Sensitive information is not required or distributed to the crowd of investors. |
| **Due diligence** | Investment deals do not have complex due diligence requirements. |
| **Ex-post investment factors** | |
| **Contractual rights** | The crowd's contractual rights are delegated to an external intermediary capable of making decisions for the crowdfunding. |

| | |
|---|---|
| **Board representation** | To allow the crowd to maintain representation on the venture's board. |
| **Value adding capability** | To allow for the crowd to value add to its portfolio of companies. |
| **Limited economic life** | Limited economic life and where the portfolio companies do not require follow on funding. |
| **Exit options** | To select deals where exits are reached quickly or where optimal exits are pre-determined. |

Source: adapted from Ley and Weaven (2011)

Ley & Weaven (2011) used the agency theory to support their investigation that was conducted over convergent interviews with 11 experienced venture capitalists from Australia. They showed that the interviewees' perceptions of the agency control mechanisms required for the adoption of crowdfunding in start-up financing represent significant barriers and restrictions to how and when the model can be engaged. They stated that "where crowdfunding can be harnessed, there is a great potential for innovation in these areas to be exploited by an interested and informed crowd of investors willing to assume these high level risks".

Although several initiatives are been taken to mature this market, there are many issues to be worked. An example is the asymmetry of information between funders and creators, typical of startups (Dos Santos et al., 2011). Administrative and accounting challenges; only internet-based, lack of advise; ideas and business models presented public can easily be stolen; investor protection and potential for fraud; current legal restrictions are not suitable for equity crowdfunding and the risky nature of small businesses are pointed to Valanciene & Jegeleviciute (2013). Mashburn (2013) complements the lack of experience and knowledge to plan and manage the capital received by entrepreneurs and the establishment of a better equilibrium between risks and responsibilities of owners and the protection of investors against frauds.

In other side, Valanciene & Jegeleviciute (2013) also show that crowdfunding to startups can help to achieve aims. For example, they cite that entrepreneurs keep the right to make company's decisions themselves. Also Positive effects crowdfunding is expected to have on economy. A niche investment opportunity and a way to raise capital.

## 4.1 Equity Crowdfunding in Brazilian Context

In Brazil, the equity crowdfunding has not taken off as other countries. We have experiences like Kickstarter American website, created in 2009, which has raised more than US$ 1 billion for startups, and Crowdcube, site created three years ago in England that is a prime example of this new modality. The service has distributed R$ 80 million to 105 entrepreneurs until March 2014 (Ferrari, 2014).

A major barrier is the high national tax burden. Micro and small businesses need to be classified in a simplified tax regime (Simples) to survive. The Simples reduces the tax burden and red tape for Micro and Small Entrepreneur's. (Di Cunto, 2014).

Conversely, according to the Journal of Economic Value (Di Cunto, 2014), at the end of April this year included a last minute amendment to the bill from Simple will allow micro and small enterprises (MSEs) access to the capital market without having to leave the simplified taxation system. This will be able to receive investments from individuals or legal entities, including corporations (S.As), among others established in the Brazilian Civil Code, and private investment funds.

The amendment was sponsored by businessmen who want to attract resources through a platform of collective funding (crowdfunding). The President of the Institute for Creative Economy, Adolfo Melito, says the group studies suggest two options: option or contract to participate in the capital of MPE, with a term of three years, or the formation of unincorporated Participation (SCP ), with the distribution of income (Di Cunto, 2014).

While the project does not gain the status of law, there are already some initiatives directed to equity crowdfunding. This is the case EuSócio. Their practices are as follows: i. The startup enrolls in an equity crowdfunding website tells you how much you want and what you do with the money. The value rarely exceeds R$ 1 million. ii. The site verifies that the information is correct. Some offer advice on the definition of market value of the startup and calculate the percentage to be sold to members. iii. In Brazil, the maximum amount borrowed cannot exceed R$ 2.4 million per year. The equity crowdfunding service gets a commission of 10% of contributions. iv. Investors wishing to buy stakes in startups make contributions ranging 100-5000 real. v. If the company prosper, investors can make money in three ways: pay dividends, buy another company or going public (Ferrari, 2014).

As there are commercial papers involved, the collective investment must be reported to the Securities Commission (CVM), the sheriff of the capital market. The Broota was the first venture to raise funds with venture capital, and the only one so far, to take this step. Obtained exemption from registration to raise R$ 200 thousand, equivalent to about 15% of the estimated value of the company, according to Rizzo, founding partner and president of the collective investment platform Broota. The platform has a portfolio of seven startups seeking between R$ 150,000 to R$ 500,000 to develop a business that will plant organic to an online learning platform beverages. But none started raking (Sorano, 2014).

## 5 Conclusion

The equity crowdfunding is already a relative with developments in other countries, especially after its regulation in the United States. Without going into deep analysis on the American environment, the fact is that the terms of the Jobs Act have attracted criticism from stakeholders, for the desired simplification and increased access of MSEs to the market seems to be complex and limited. Still, the event has already raised interest in Brazil, leading discussions and opportunities for national MSEs make use of similar instruments (Picchi, 2013).

Like any novelty, the equity crowdfunding model does not yet provide a solid legal framework sufficiently to bring legal certainty to Brazilian investors. In apparent contradiction to all that was written above, however, we can realize an enthusiasm of the new dynamics of access to resources. A hope of entrepreneurs is the possibility of CVM include it in a public hearing within the commission in 2015, for the purpose of discussing the rules (or not) of the subject. Who knows, since then, we have a horizon less gray on the subject? (Menezes & Rosolen, 2014).

Picchi (2013) believe that the actual experience will tell if these emissions regulatory pathways are effective, or if improvements are possible. Besides, more importantly, could provide subsidies to stimulate discussion on ways to reduce barriers to investment in startups, innovative and high potential. The discussion cannot fail to take into account changes in the tax laws to include, in particular, tax incentives and deferrals, as has been defending the Program to Accelerate Growth for Small and Medium Enterprises (SME-PAC) (Picchi, 2013).

The initiative and persistence of EuSócio and Broota platforms shows interest in the consolidation of this type of fundraising in Brazil. The Catharsis is a Brazilian crowdfunding platform for success. Indeed, demand for startups is low. Most seem to have more focus on disclosure of their projects than on fundraising.

Considering the possible changes in this scenario, we suggest future research dealing with how projects financed have been launched and what were the alternatives adopted for return of investor capital. Furthermore, research dealing with forms as investor capital is protected may also contribute to this field of study. The issue of accounting and financial transparency deserves attention, dealing with taxation, supervision and specific regulations.

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